Queen's University

Course in Banking

LESSONS X-XI

Corporation Finance

LESSON X.

Insolvency and Reorganization.

The many advantages of the corporate organization of industry have been described in a previous Lesson. It was found that the corporation is best adapted to those enterprices which meet a widespread demand for their goods or services; where the volume of business is fairly steady; and where profits may be expected to be reasonably uniform. Under such conditions cases of insolvency should seldom arise. But as such do occur it is important that we should understand their causes and effects.

It is well to distinguish between two types of insolvency. The one may be called "true," the other "legal" insolvency. The former occurs when the liabilities exceed the assets. Such insolvency may or may not lead to failure. Unless the obligations must be met at once it frequently happens that the corporation can get out of its difficulties and meet its debts as they fall due. On the other hand, legal insolvency occurs when a concern's cash assets are not sufficient to meet its current obligations. The assets may far exceed the liabilities, but if the latter cannot be met in cash as they fall due the concern becomes insolvent. Failure to pay debts as they mature leads to suspension of the business and finally to bankruptcy, unless some arrangement is effected with the creditors.

Why insolvency occurs. In some instances insolvency may exist from the commencement of business because of the over-valuation of assets. When a company is over-capitalized in this way failure almost inevitably follows, unless through some combination of circumstances earnings should increase to an extent sufficient to carry the outstanding obligations in the shape of bonds, and to pay dividends upon the stock.

Again, some unforeseen accident may destroy the value of the assets and compel a corporation to go into liquidation. A port may lose its trade because of development of shipping facilities elsewhere; a town may be sidetracked by the growth of large wholesale centres elsewhere; a district may lose its natural advantages through the exhaustion of the natural resources upon which its prosperity depended; a disastrous fire may wipe out a whole town or city; or a thousand and one other factors may obtrude to destroy the value, in whole or in part, of the assets of a corporation and compel its reorganization or liquidation. In part, of course, these contingencies can be foreseen and provided against by applying the principles of insurance and depreciation; but in other instances

foresight or care can prevent the resultant decline in earnings and depreciation in the value of the fixed assets.

Another cause of insolvency is bad management in carrying on the business. In some cases it would appear that the business is flourishing, whereas it is being carried on below cost. This may continue for a number of years before it is discovered that the capital has been used up in large part for running expenses. It is necessary, therefore, that a searching analysis of a company's affairs should be made from time to time to discover the actual value of the fixed assets and the cost of conducting the enterprise. This is not difficult in the case of a trading concern, but it is a serious enterprise in the case of the railroads. It is doubtful whether the benefits received would be worth the very large costs involved in getting at the actual value of railway property. Recently various acts passed by the United States Congress provided for an evaluation of American railway lines. It was foreseen that the cost would be heavy, but the outlays so far have exceeded the early estimates. A statement of what is being done in the work of getting at the value of the railways was recently made in Congress by Charles A. Prouty, formerly a member of the Interstate Commerce Commission, but now in charge of the work of making an evaluation of the railroads. The following is a summary of Mr. Prouty's report, taken from the New York "Journal of Commerce":

"Last year the railroad-valuers asked for $2,000.00. They now ask $3,000,000. As in all, about $2,400,000 has heretofore been appropriated, the total up to the end of the coming fiscal year on the basis stated would be $5,400,000. Work today is going on at the rate of $2,000,000 annually, but more rapid development is now called for. Mr. Prouty has given some interesting details as to the progress of this part of the work also, stating that of the $2,000,000 annual outlay over $500,000 is what may be called overhead expense, the balance being for field work. Inasmuch as the field expense does not call for increased overhead charges in proportion as it enlarges in scope, the recommendation is made that more stress be placed on the field work. About 20,000 to 25,000 miles of line per annum are being examined at present, and it is desired to enlarge this to 50,000. If the latter rate should be obtained the field portion of the valuation work would be finished by four years from July 1, 1915. At present eight parties are in the field doing the work in each of five districts into which the country is divided, or forty parties in all. With this staff about 2,000 miles a month, or 24,000 miles per annum, can be covered.

"Assuming that there are 250,000 miles of track in the United States and that the cost of valuation at the rate of

24,000 miles a year is $2,000,000, the total cost would be something like $21,000,000. Something between $18,200,000 and $21,000,0000 would be the Government's outlay—a very different figure from the three or four millions roughly estimated by some when the scheme was first projected. True, some estimates still run as low as $16,400,000, but actual experience gives the results just stated.

"The expense to the government is only a part of the cost of the work. There has been much difference of opinion on this subject, but Mr. Prouty when questioned afforded some data. At first he was inclined slightly to depreciate the work of the roads to some extent, saying: 'They are doing more talking than they are work up to the present time, but,' he went on to say, 'some of them have done a good deal of work. The Boston & Maine road, for example, which is poor and can not afford it, has been obliged to do a great deal of work, and is laying out a great deal of money.' Asked what the valuation was costing the Boston & Maine, Mr. Prouty said, 'one hundred dollars a mile.' This, moreover, would be the cost for the balance of the system. At this rate the cost to the railways of the United States for 250,000 miles would be $25,000,000. Mr. Prouty afforded a basis also for a different mode of estimate. It would, he said, cost the Government for its work 'about half' the outlay of the Boston & Maine. If the cost to the Government is $20,000,000 for valuation, the cost to the roads would thus appear to be about $40,000,000."

It is doubtful whether the cost will justify the results obtained; but the case of the smaller corporations is somewhat different, especially of the trading concerns. Here a careful calculation should be made from time to time to see that the assets of the company are not being dissipated in running expenses, the cause of failure in many a concern that seems to be prosperous and which, at all events, has been carrying on a large business.

Causes of legal insolvency. The great mercantile agency Bradstreet's, presents the following statistics on legal insolvencies in Canada for the years 1911 and 1912. It should be noted that the failures are a very small percentage of the large number of companies carrying on business in the Dominion:

Failure due to—	Number.		Assets.		Liabilities.	
	1912.	1911.	1912.	1911.	1912.	1911.
Incompetence	214	226	$1.121.328	$1.317,774	$ 2,815,349	$ 2,471,299
Inexperience	67	41	204.761	93,032	435,468	200,851
Lack of capital....	660	691	2.784,605	2.930,854	5,660,668	6,249.820
Unwise credits ...	17	12	148.524	62.250	204,744	130,244
Failure of others..	12	16	77,967	117,125	311,333	188.023

Extravagance	11	12	29,460	308,000	65,510	417,900
Neglect	56	58	172,871	183,610	377,384	332,792
Competition	13	15	39,538	33,699	78,598	74,150
Specific conditions.	168	204	659,019	780,504	1,081,139	1,314,687
Speculation	6	13	23,800	123,600	53,600	406,486
Fraud	88	133	349,802	469,883	1,271,129	1,300,757
Total	1,312	1,401	$5,611,675	$6,420,331	$12,355,282	$13,086,946

It will be seen from an examination of these figures that "lack of capital" heads the list, followed by "personal incompetence." As a rule, however, it is not lack of permanent capital that causes insolvency, but rather the failure to keep a sufficient percentage of the capital in the shape of "quick" assets. It may be said, therefore, that the lack of earning power in a corporation may result in inability to meet fixed charges and thus bring about true insolvency; while lack of working capital will produce legal insolvency.

Competent accountants lay down the principles that a concern should not permit its accounts payable to exceed 80 per cent. of its accounts receivable; that its bank loans should be represented for the most part by cash in the bank; and that the finished products on hand should not be offset by any corresponding liability. A corporation begins to lose money as soon as it fails to take advantage of cash discounts from the prompt payment of bills. It is certain that if working capital is not available to carry on the business the manager must depend upon sales and accounts receivable to pay his bills. If, for any reason, debtors fail to pay promptly or sales fall off, he will be unable to meet his own obligations. Unless, therefore, he can make new arrangements with his creditors the concern may be forced into liquidation.

In Canada wholesalers and manufacturers have shortened the period of commercial credit from four months to three. There are certain dates in the year of particular importance when settlements are made; and if for any reason many accounts have to be carried over the seller may find himself in a serious position. As has been said, he must himself provide for an extension of credit or face failure, unless the assets of the concern have been kept in a liquid form. The following review of actual trade conditions in Canada for a specific period is interesting and important as throwing light on the problem discussed. We quote from "The Toronto Globe" (March 5, 1915):

"The Fourth of March."

"Once the apex of the most critical period in the commercial year, and the settling day on the heavy contracts entered into by country merchants for the Christmas and winter trade, March 4 has lost some of its significance, but it still furnishes

one of the conclusive readings of the commercial barometer. The tendency of late has been to shorten the period of commercial notes from four months to three, and now the majority of these obligations mature on February 4. Payments upon that date this year were admittedly disappointing, a large percentage of the country merchants, especially those in the West, requiring extensions and renewals. Although it will be several days before the character of the general response to the drafts sent out by the eastern manufacturing and distributing houses this week is known, there is evidence that the situation is improved, and that retail merchants throughout the country will be able to make more liberal remittances to the manufacturing centres than at any time since the war began. The credit men of large establishments, who occupy a particularly advantageous opportunity of judging trade conditions, are inclined to place the responsibility for tardy remittances of retailers, following upon the slow payment of accounts by customers, to a popular dread of drawing upon savings rather than to an inability upon the part of the ordinary debtor of the country merchant to pay. The credit men call this excessive devotion to savings the "hard-times microbe," and current commercial statistics not only support their theory, but indicate that the spirit of economy is being as rigidly enforced in corporate and in personal expenditure now as it was recklessly ignored a few years ago.

"Trade statistics usually employed in estimating the prosperity of business generally have been interpreted during the past few months as evidences of a semi-collapse of the buying power of the country. It is a question whether in jumping at this conclusion too much emphasis has not been placed upon the drastic reduction in the revenue of railroads, the heavy decrease shown in bank clearings, and the remarkable contraction in the volume of banking credits to the commercial community. Most of these changes were produced by an inclination to save rather than an inability to spend. Savings entrusted to the banks are beginning to increase more substantially than when the country was flushed with easily earned wealth. The gain in savings deposits in the chartered banks alone in January were $4,130,000, and at the end of that month they were $31,824,000 in excess of the same month of the year previous. At the end of January thrifty Canadians had in savings deposits in the chartered banks $666,960,000. This is the best test of the national credit position. It shows that the people as well as the lending institutions which have successively presented exhibits of great financial strength, based upon their possession of large amounts of unemployed capital, have been able to make preparations for any untoward contingency later on.

"Other commercial data indicate that the promise of the fields now being laid bare by the increasing strength of the March sun is being reflected in trade. Toronto's bank clearings for the week ending yesterday showed a gain of $4,000,000 over the previous week, and made the best record since the second week in January. Montreal clearings for the same period reported an increase of $5,000,000, and were also the best since the third week in January. Although they still fall millions below the boom period, these clearings, divested as they are of all inflation due to the stock market and real estate speculation, and accentuated by the zealous practice of thrift, do not make as unfavorable a comparison as a superficial contemplation of the figures would suggest.

"Railway earnings, which were dragging on the bottom during the winter, are now beginning to show an upward tendency. The season of heaviest operating costs is past, and gross earnings are at least holding their own. The country is nearing the season when necessity will stimulate the movement of goods across the counter, and when the demand from the rural districts particularly will be sufficient to give a further impetus to trade.

"March 4 may have lost some of its significance as a red-letter date in the commercial calendar, but it should receive some tribute, because it seems to mark the end of a long and trying experience from which we have emerged with clipped wings perhaps, but with a whole body."

Whether one agrees or not with the conclusions of the writer of this article is immaterial. The important fact to notice is that underlying conditions may be such that those to whom credit has been advanced cannot meet their obligations; and in that event it is essential that the business concerns of the country should be in a position to safeguard their own interests.

As has been pointed out already, a concern may fail although its assets far exceed its obligations, and although it may have a large and growing business yielding handsome profits. The cause of failure in this case is neglect to provide a sufficiently large working capital.

A somewhat similar condition arises when a corporation is obliged to unduly increase its quick obligations to pay dividends that have been earned but not provided for. The profits that have been earned my have been put back into the business, and hence it may be necessary to borrow money temporarily to pay the dividends. This is a dangerous practice. As has been already explained, dividends should be provided for in advance, so that it will never be necessary to endanger the corporation's working capital.

Corporations may face legal insolvency also through inability to renew medium-term notes or to refund long-term obligations when they become due. This may come about through an unfavorable conditon of the money markets when it is next to impossible to borrow on any terms. The sudden outbreak of war in Europe embarrassed many corporations in Canada and the United States, and in the latter country several railroads were forced to go into the hands of a receiver. Under such conditions the directors are not to blame for the crisis the corporation has to face, as it is impossible to predict, years in advance, what the condition of the money market will be when the refunding operations must take place.

Bankruptcy and dissolution. Before we discuss the problems of reorganization it will be necessary to outline briefly what is involved in the liquidation of a corporation. Under the British North America Act (Section 91), the Dominion Parliament alone has jurisdiction over bankruptcy and insolvency in Canada. In the absence of a Dominion bankruptcy act, however, the several provinces have passed legislation—Voluntary Assignment Acts—providing the mechanism under which persons or partnerships may voluntarily go into liquidation and distribute their assets among their creditors. The greatest defect of this procedure is that after the assets are surrendered it is impossible for the debtor to free himself from further obligations until all liabilities have been discharged in full. In the United States, however, where there is a National Bankruptcy Act, the debtor may begin business again with a clean sheet after he has made a general assignment of his assets for the benefit of his creditors.

Let us now consider the question of the liquidation of corporations, keeping in mind that the Dominion Parliament has exclusive jurisdiction over questions of bankruptcy and insolvency.

The Dominion Winding-up Act is an important piece of legislation covering the liquidation of incorporated companies. It applies to:

All corporations incorporated by or under the authority of an Act of the Parliament of Canada, or by or under the authority of any Act of the late Province of Canada, or of the Provinces of Nova Scotia, New Brunswick, British Columbia or Prince Edward Island, and whose incorporation and the affairs whereof are subject to the legislative authority of Canada; and also to incorporated banks, savings banks, incorporated insurance companies, loan companies having borrowing powers, building societies having a capital stock, and incorporated trading companies doing business in Canada wheresoever incorporated and—

(a) Which are insolvent; or

(b) Which are in liquidation or in process of being wound up, and, on petition of any of their shareholders or creditors, assignees or liquidators, ask to be brought under the provisions of this Act.

In considering the application of the act, Canadian companies may be divided as follows: (1) Companies incorporated under general or special act of the Parliament of Canada; (2) companies incorporated under general or special acts of the Provinces before Confederation, which (a) if incorporated since Confederation should be incorporated under general or special acts of Parliament and (b) which if incorporated since Confederation should be incorporated under general or special acts of Provincial Legislatures; (3) banks, insurance companies, loan companies having a capital stock, and trading companies; (4) provincially incorporated companies. (1) and (2a) are within the provisions of the act whether insolvent or not; (2b), (3) and (4) which are within the description (3) are within the provisions of the act if they are insolvent or being wound up; and (4) which are not within the description (3) are not within the provisions of the act.

In connection with what has been said it should be observed that while Ontario has a Winding-up Act it applies only to companies that are not insolvent and that go into voluntary liquidation. The further comment should be made that a company incorporated under the Ontario Companies Act and carrying on business in that province is "doing business in Canada." So, too, is a foreign company, wherever it may have been incorporated, that is carrying on its activities in this country. The courts of Canada are entitled to protect Canadian creditors of foreign corporations, to the extent that such corporations have assets in this country. Finally, it should be observed that the act does not apply to building companies that have no capital stock, or to railways or telegraph companies.

The determination of insolvency. A company may be declared insolvent under the act, among other reasons:

(a) If it is unable to pay its debts when due.

(b) If it calls a meeting of its creditors for the purpose of compounding with them.

(c) If it exhibits a statement showing its inability to meet its liabilities.

(d) If it has otherwise acknowledged its insolvency.

(e) If it assigns, removes or disposes of, or attempts to assign, remove or dispose of any of its property, with intent to defraud, defeat or delay its creditors at any time.

A company is deemed to be unable to pay its debts as they become due when a creditor in a sum exceeding $200

has made legal demand for payment; and the company has, for ninety days in the case of a bank, and for sixty days in all other cases, neglected to pay or secure or compound for the sum claimed. By a demand is meant, not a writ of summons, but a demand for immediate payment, reasonably certain in terms and not calculated to mislead.

When a winding-up order will be granted. The court may grant a winding-up order:

(a) Where a company's charter has expired; or when the event, if any, has occurred upon the occurrence of which the charter provides that the company is to be dissolved. The order, in such case, is made at the instance only of the company or of a shareholder.

(b) Where the company, at a special meeting of shareholders called for the purpose, has passed a resolution requir- the company to be wound up. Here again only the company or a shareholder may petition.

(c) When a company is insolvent. In this case the petitioning creditor's claim must be for at least two hundred dollars. If a shareholder petitions he must hold stock of the company to the amount at least of five hundred dollars.

(d) When the capital stock of the company is impaired to the extent of twenty-five per cent., and when it is shown to the satisfaction of the court that the lost capital will not likely be restored within the year.

A shareholder only may petition, and he must hold at least five hundred dollars of the company's stock.

(e) When the court is of the opinion that for any other reason it is just and equitable that the company should be wound up.

A shareholder, qualified as above, alone can petition.

Duties of liquidator. When the petition has been granted and the winding-up order given, a provisional liquidator is appointed who takes temporary possession of the company's affairs and assets. A meeting of creditors, shareholders and contributories is then called to appoint a permanent liquidator and inspectors. It is the duty of the liquidator to make an inventory of the company's assets, and to call in all claims against, and collect all debts due, the company. Under certain conditions he is authorized to continue the company's business. When he has liquidated all assets he prepares a dividend sheet. If the sheet is not contested within a prescribed period he pays the dividend and obtains his discharge from the court.

Many Canadian creditors lose large sums annually because they are inclined to accept their losses

without further question and write them off to "experience." Too often they leave the details of arranging for liquidation proceedings to the large creditors. In some cases the latter do not properly safeguard their interests, shirking individual trouble and responsibility. The result is that when the inspectors, solicitors and the liquidator have got through with the property there is little left to distribute. Creditors need to be educated in this country to the need of taking energetic action to protect themselves against fraud in the first place, and the looting of the property in the second, by those who make a practice of disposing of insolvent estates.

Principles of Reorganization.

Reasons for reorganization. It must not be supposed that a corporation that gets into financial difficulties, whereby it is unable to meet its obligations, must necessarily go out of business. On the contrary it is often the case that the creditors gain most by consenting to some scheme of reorganization whereby the business is continued as a going concern.

There are two general classes of reorganization; first, those that are necessary as the result of insolvency, and, second, those that are brought about to readjust the securities and hence the control of the property. In most cases, however, financial difficulties of one kind or another have operated in bringing about the reorganization of corporations.

We have already alluded to the advantages of reorganization in lieu of a simple sale of the property. Take a great railway system, for example, with a main line and numerous "feeders." The parent company will own, in that case, the securities of a number of subsidiary companies, each of which in its turn will have junior and senior mortgages outstanding. The parent company may have deposited with a trust company, as the basis of a collateral trust bond issue, the stocks and bonds of the subsidiary companies, which it holds. The parent company may also own several branch lines, with outstanding mortgages on each. In addition mortgages may have been placed on the terminals and on whatever real estate is held, as well as other property. Besides the bonds of all kinds outstanding there will be issues of common and preferred stock and short-time notes; and in addition other liabilities will have to be met, including accounts payable, bank loans and accrued wages. All this seems very complicated; but as a matter of fact it is not half so complicated as are the obligations and relationships of many large industrial and railway corporations.

Yet, for all practical purposes, the railroad property is an indivisible unit. It would avail any group of creditors little or nothing to take possession of any particular branch line, terminal or other property. The value of the mortgaged line or terminal depends upon its relationship to the whole property as a going concern. The property, then, of most large corporations, and particularly of railroad corporations, is indivisible. The various parts must be kept together if they are to retain their value. The question that arises in case of insolvency, then, is, How can the property be held together, and restored to its right position as a valuable profit-making business? Every bondholder and every stockholder is interested in getting at the right solution of that problem.

Usually, the first thing that is done is to form committees representing the various bonds that have been issued. As a rule these committees are dominated by men who hold or control large blocks of the several kinds of securities outstanding. In some cases banking houses which have underwritten one or more of the bond issues come forward and offer to serve on the reorganization committees. Ordinarily it is not essential that the first mortgage bondholders should organize, as they are well protected, and can afford to let the other creditors first fight it out. Usually the stockholders do not organize as they have practically no voice in the conditions of reorganization. When the committees have all been formed they proceed to estimate the value of their various claims and the precedence of each.

We have already considered in part why the bondholders as a whole, or as a class, do not foreclose and sell under their mortgage, or bid in the property for themselves. If the property were sold, each bond would be accepted at its par value. It should be observed, however, that it would be next to impossible to sell a large corporation to an outsider for cash, because the amount involved would be too large. Besides, an outsider would prefer rather to buy the securities at a low price during the period of reorganization, and get control of the property in that way. And moreover, the first mortgage bondholders would get nothing more than principal and interest from such a sale, which, presumably, are well protected already. Those holding junior securities might gain something by foreclosure, although they might be forced to settle all claims that rank ahead of their own, in cash. The possibility of their taking such action, however, forces the reorganization committee to treat their claims with respect.

The first duty of the reorganization committee, therefore, is to get at some working estimate of the relative value of the different classes of securities. The bonds of various descriptions—junior and senior mortgages, general mortgage bonds,

debenture bonds, etc.—are first evaluated, and their claims on the earnings and assets of the corporation determined. Then the committee will consider what must be done for the preferred and common stockholders. In heavily over-capitalized concerns the common stock will be wiped out absolutely. An effort is made to preserve something for the preferred stockholders, although as a rule they are requested to pay certain cash assessments to preserve their interest in the property.

Why capital is needed. Cash will be needed at once to clear off the floating debt of the corporatio' Such debts may consist either of loans or medium-term notes secured by specific pledge of property, or of unsecured obligations, such as accounts payable. Whether these debts are secured or not, they must be discharged, otherwise property essential to the success of the reorganization will be attached. In addition to the taking care of these obligations a fund for working capital must be secured, otherwise the corporation will at once get into new difficulties. And, finally, the reorganization committee must see that the fixed charges are no greatr than the minimum net earnings. There are thus four main objects of every reorganization: (a) the payment of the floating debt; (b) the providing of working capital; (c) the bringing of the property into a condition of efficiency; (d) and, lastly, the reduction of fixed charges below minimum earnings.

> *No reorganization policy that neglects these essentials, or any one of them, can hope to meet with success. A company that begins without sufficient working capital will at once find itself in difficulties and at a time when it is highly necessary to keep its credit good. On the other hand, if the minimum net earnings are not sufficient to meet fixed charges, a further reorganization must take place, which will do almost irreparable damage to the corporation's position in the money markets of the country.*

Methods of raising capital. The first three of the objects mentioned above require cash in considerable amounts, because a company that is approaching insolvency almost always lets its accounts payable accumulate, its working capital decline, and its property to fall into disrepair. The reorganization committee, therefore, must first of all secure cash; and, secondly, reduce its fixed charges.

There are three obvious methods of raising money for these purposes: first, by the sale of some of the company's property; second, by the issue of new securities; third, by

assessments on the security holders. The first two methods are, as a rule, not practicable of accomplishment, for such property as is non-essential to the business will be turned over to mortgagees; and in addition the company will have exhausted its borrowing powers. Of course, these conditions will not apply if the company is not insolvent, but has merely suffered a temporary setback. And, moreover, as has been said, even in cases of true insolvency cash is raised at times by the issue of receiver's certificates.

But the third method—the securing of cash by assessment—is generally followed. Naturally the heaviest assessments will fall on the common and preferred stockholders. What will be secured in this way will depend upon the value of the stock in the reorganized concern. But experience has shown that the stockholder will do better if he stays in the concern than if he forfeits or sells his shares. Sometimes the junior bondholders, although they are creditors, must pay a cash assessment also to help set the business on its feet. If the stockholders are asked to carry the whole burden of finding the cash the bondholders may be left with the property on their hands and thus have to carry the whole burden themselves. Finally, it should be observed that, as a rule, the cash needed by a company is not all required at once, and the terms of payment of the assessment may be therefore made fairly easy.

> *Great care should be observed during the process of reorganization to do substantial justice to all concerned, not only in arranging for the new capitalization but in providing for cash requirements. As a rule the stockholders of a big concern have appointed men of conspicuous ability as directors. It is necessary to preserve the connection of these men with the business, not only because of their ability but because of their knowledge of the concern's affairs. The cash contributions, therefore, should not be excessive; and, if necessary, the bondholders should help carry the burden.*

Reducing fixed charges. In arranging the reorganization three fixed charges, as a rule, must be dealt with: guarantees, rentals and interest. A reorganized company may make better terms with the holders of the guaranteed stock and bonds of subsidiary concerns and with the owners of leased property. This, as a matter of fact, is generally done. If the company is dissolved in the reorganization process, the new company is freed, of course, from the terms of the original contracts.

But far more important in its effects on fixed charges is the substitution for the interest-bearing securities of the old

corporation of dividend-paying securities of the new. Then again, old securities bearing a high rate of interest are converted into securities bearing a low rate of interest The result of this readjustment, if the reorganization is to prove successful, must be to bring the total fixed charges below the net earnings of the corporation even in the worst years. Care must be taken, of course, to give the holders of the various class of securties the same relative protection and value of interest in the reorganized company as they had under the old condition of affairs. The reduction is not proportionate on all the bond issues, but is adjusted in accordance with the relative strength of the various claims against the corporation. As a rule the committee will arrange for a few well-defined mortgage issues in place of the numerous mortgages previously existing, and will increase the amount authorized under each issue. But the old first mortgage bonds and the first mortgage issues on important pieces of specific property will generally be left untouched. On top of them the company may place a new general mortgage bond issue of sufficient size to refund all the existing issues that are to be absorbed, to refund the old first mortgage bonds when they fall due, and to provide for necessary improvements and extensions. In time this general mortgage will become a first lien on all the corporation property. Generally, the junior bonds will be exchanged for the new general mortgage bonds under conditions to be arranged.

The second mortgage bonds, the branch line bonds, and the debenture bonds are then, as a rule, exchanged for general mortgage bonds. Let us suppose that there have been outstanding $1,000,000 second mortgage bonds, $500,000 branch line bonds, and $1,500,000 debenture bonds, and that the new general mortgage bonds available for exchange are fixed, on the basis of lowest earning capacity, at $2,000,000. Suppose further that the committee has estimated the first-named issue on the basis of lowest earnings at 80 per cent. of their par value, and the second and third issues at 60 per cent. of their par value. The second mortgage bondholders would then be offered $800 in new general mortgage bonds for each $1,000 of the old; and the bondholders of the second and third classes would be offered $600 of the new bond for each $1,000 of the old. As the values of the old issues and the amount of the new issue are based on lowest net earnings they must, of course, exactly correspond. Preferred stocks are given to bring the amount of their par holdings up to the old amount, often considerably more. This may greatly increase the capitalization of the new concern; but at the same time it reduces fixed charges, the great object in view in conducting the reorganization.

Mr. W. H. Lough, in "Corporation Finance," sums up the principles and results of reorganization as follows:

(a) The reorganization must remove the immediate causes of bankruptcy by providing cash and at the same time reducing fixed charges.

(b) The reduction of securities bearing fixed charges may well be, and usually is, accomplished by a great increase of dividend-paying securities.

(c) In determining who shall stand the losses caused by the company's insolvency, the reorganization committee will first rank the securities in the order of their safety and will then impose the losses in inverse order.

(d) In so doing the directors must of necessity consider primarily the ability of the security-holders to make trouble for or to wreck the reorganized company if their demands are not satisfied.

(e) In raising necessary cash they will naturally impose the first and heaviest assessments on stockholders; but they must bear in mind that if they go beyond certain limits the stockholders will forfeit their shares rather than pay the assessments.

> *A very careful study should be made of all the above conditions to determine the principles that should operate in effecting a successful reorganization. Much capital has been lost in Canada and the United States through a failure to understand the underlying factors involved. If a successful policy of reorganization can be agreed upon it goes without saying that there will be a very great saving of property effected.*

A typical reorganization. Many examples of the reorganization of companies in Canada might be given, but one illustration must suffice. The following gives a brief outline of the career of the Amalgamated Asbestos Corporation, and admirably illustrats some of the important principles which have been discussed:

The Amalgamated Asbestos Corporation, Limited.

The year nineteen hundred and nine was a merger year in industrial and financial Canada, fifty-two companies combining into ten amalgamations with a total capital of $195,500,000. Toronto and Montreal financiers promoted most of the enterprises whose flotations were made largely in London, though some United States capital was contributed.

The first large undertaking of the year was the organization of the Amalgamated Asbestos Corporation, Limited, the prospectus appearing early in April. Its capital was as follows:

	Com. Stock.	Pref, Stock.	Bonds.	Rate.
Authorized	$8,125,000	$1,875,000	$15,000,000	5%
Issued	8,125,000	1,875,000	7,500,000	...

Total authorized capital, $25,000,000.

The following companies entered the merger:

Name.	Capital.
British Canadian Asbestos Company, Limited..	$1,000,000
King's Asbestos Mines	1,600,000
Beaver Asbestos Company	300,000
Standard Asbestos Company, Limited........	150,000
Dominion Asbestos Company, Limited	500,000
Properties of R. T. Hooper	......
	$3,500,000

The seven per cent. preferred stock was cumulative and convertible, share for share, into common stock at the option of the holder. One-half the bonds were issued, being underwritten at par and carrying a bonus of 25 per cent. common and 25 per cent. preferred stock. Messrs. Cramp, Mitchell & Shober, of Philadelphia, were the syndicate managers, and financial arrangements were carried out by the Bank of Montreal and the Bank of Commerce.

The prospectus declared that the company would commence business with no liabilities save its funded debt, with the properties fully paid for, and liquid assets and working capital of about $900,000.

The attention of readers was drawn to the fact that improvements in selling and economies in operation would be introduced to increase largely the earnings of the company over those of the constituent companies operated individually, "thus assuring continued increase in surplus earnings, applicable to payment of dividends on common stock."

The new company claimed to control about 70 per cent. of the total supply of asbestos in the world.

The organization meeting was held in Montreal on June 5, when the following officers were elected:

E. B. Greenshields, President, Montreal; Hon. Robert Mackay, Vice-President, Montreal; Howard Ellery Mitchell, Second Vice-President, Philadelphia; and a board of twelve directors, four of whom were Canadians, seven Americans, and one from London, Eng.

The consolidation resembled recent American mergers and was promoted largely by United States interests. The issue met with great success, entering the market in good shape, later settling back ten points, but soon recovering. In October the stock was listed on the exchange with trading in

preferred stock ranging between 90 and 91 and in common stock between 32 and 32½.

When the flotation took place in 1909 one-half the bonds were issued, which were fully paid for by the underwriters who received the bonus of [illegible] per cent. common and 25 per cent. preferred stock.

The business of the first six months was very satisfactory. Earnings demonstrated the ability of the corporation to pay interest on bonds, dividends on preferred stock and a balance of 2 per cent. on common stock.

The president's circular to shareholders contained the following:

"Under the initial period of operation the output did not increase greatly over the previous year, [illegible] mines were operating separately. It is expected that [illegible] company will reap advantages of specialization and [illegible]ation; also, that the output will reach a new record figure and that prices will be higher than previously. The company now has contracts aggregating upwards of $3,500,000 on its books, and is working to its limits in order to keep up to the demand."

About the middle of February, 1910, an advertisement appeared declaring that "perhaps the biggest public issue ever attempted by a Canadian industrial concern is that which will be announced in a few days by the Amalgamated Asbestos Corporation of $7,000,000 bonds, the offering to be made simultaneously in London, New York, Philadelphia, Boston and Montreal and Toronto."

On February 21 the issue was announced. Messrs. Cramp, Mitchell and Shober took charge of the American, while Kilcat and [illegible]itken handled the English allotment. The bonds were divided into $500 and $1,000 and offered at 92½ flat.

The London correspondent of the "Monetary Times" wrote on March 9, 1910, as follows: "The Amalgamated Asbestos Corporation offered some $7,000,000 first mortgage thirty-year 5 per cent. sinking fund Gold Coupon Bonds at 92½. The result in London has been satisfactory, and although the prospectus has been criticised in some directions, the general reception has proved satisfactory."

On April 30, 1910, application was made to the London Stock Exchange to list Amalgamated Asbestos Corporation £2,017,000 fives.

In the latter part of 1910 an issue of [illegible]300,000 of bonds was sold at 85.

The business, however, showed signs of falling off, and at the annual meeting in March, 1911, the statement covering the previous seven months showed that during that period the profits amounted to $195,424, while the [illegible] interest paid and accrued for the period amounted to $[illegible],325.

The following comment on the condition of the company was made by the "Monetary Times," of March 11, 1911: "The report is one of the most discouraging that has been issued for some time in connection with a company of the magnitude of the Amalgamated Asbestos. The profits for the seven months were nearly $60,000 less than sufficient to meet the bond interest and dividends on preferred stock. It was doubtless in anticipation of some such result that the directors decided to pass the preferred stock dividend last summer."

Mr. McDougall, the president, admitted that the year had been discouraging, but in addressing the shareholders, sounded a note of optimism, claiming that it was confidently expected that the future had better things in store for Amalgamated Asbestos.

One of the most interesting statements made was that the $300,000 bond issue had been sold at 85 and that negotiations were nearly closed for the sale of $200,000 more at the same figure. Since no sales of bonds had been made recently in the open market at higher than around 70, the disposal of large blocks at 85 was evidence that financiers had more faith in the future of the company than had the investing public.

But these hopes were soon dissipated and at a meeting on November 27, 1911, the directors resolved to default the bond interest due on December 1 following. The Royal Trust Company was requested to call a meeting of the bondholders for the 25th of January, 1912.

The balance sheet issued on Decemeber 31, 1911, showed that the profits for the year were $98,003, compared with $396,-799 bond interst for the year. The profits were insufficient to meet even operating expenses, being $54,914 short of the sum required, so that with $396,799 bond interest not paid the deficit was $451,713.

The following is a copy of the balance sheet of December 31, 1911:

Liabilities—

Preferred Stock	$1,875,000 00
Common Stock	8,125,000 00
First Mortgage 5 per cent. bonds	8,000,000 00
Accounts payable and pay rolls	87,452 18
Bills payable	328,840 13
Bond interest accrued	233,333 31
Contingent account	118,640 00
Reserves	17,248 20
	$18,785,513 82

Assets—

Property, plant improvements, etc.		$17,310,486 78
Discount on bonds		75,000 00
Asbestos on hand		693,665 01
Inventories		172,689 03
Taxes, insurance prepaid		14,143 55
Accounts receivable		47,937 71
Cash		19,877 75
Deficiency	$ 396,799 07	
Add bond interest for year	396,799 07	
		451,713 99
		$18,785,513 82

The president issued a brief circular announcing the default of the bond interest. It claimed that the smallness of the profit was due in part to diminished production, which was only two-thirds of the effective production of the mills, the large mills being stopped most of the time. The British Canadian and the Beaver Mills, two out of five, produced practically the entire output.

The circular enumerated difficulties with which the company had to contend. The system of grading was defective, dissatisfying critical buyers. Changes in machinery caused loss of time and money, and the prices of crude asbestos had abnormally declined.

At the bondholders' meeting in January, 1912, a committee consisting of Messrsfl J. E. Alfred, Uzal H. McCarter and H. J. Fuller was named to enquire into and propose a solution of the company's difficulties, and to report thereon at a meeting to be held four days later.

The committee's report called for a reorganization of the company with a reduced capitalization, so that the fixed charges would be so low that under no circumstances would the company at any time face a default.

Briefly, the holder of $1,000 bond was to get in exchange a $250 bond; $500 in preferred stock and $250 in common stock. Bondholders and old shareholders were invited to subscribe for $85,000 new 5 per cent. bonds on a basis of 85 for bonds, which carried 100 per cent. bonus of common stock. This was to provide new working capital.

The new company known as the Asbestos Corporation of Canada, Limited, took over all the property, plants and assets of the defunct company.

Its capitalization was as follows:

	Com. Stock.	Pref. Stock.	Bonds.	Rate.
Authorized	$3,000,000	$4,000,000	$5,000,000	5%
Issued	3,000,000	4,000,000	3,000,000	...

The bonds of the previous company amounted to $8,-000,000. These were covered by an issue of $2,000,000 bonds, $4,000,000 preferred stock and $2,000,000 common stock. To provide working capital a further issue of $1,000,000 of bonds, together with $1,000,000 common stock was made.

The "Monetary Times" criticized the insolvent company in plain terms. It said:

"The bondholders' values have depreciated 75 per cent. The stocks thrown in as a sop are of a remote value. We have yet to learn that any other supposedly business-like corporation has ever run its affairs in a way which has ultimately entailed the absorption of three-quarters of the bondholders' securities in order to square matters. That fact alone is sufficient to damn in the eyes of British and foreign investors, any further offering of the promoters of the Amalgamated Asbestos Corporation. The bondholders' committee has apparently deemed it necessary to plaster their report with excuses. The results of operation, they claim, have been materially affected by difficulties in obtaining practical management and a general demoralization in the market for asbestos."

The kernel of the whole thing lay in the original excessive capitalization involving a fixed charge of $400,000 per year. Besides, the company was inefficiently managed and had to face the cut-throat competition of a rival company, the Black Lake Asbestos Company, organized a few weeks after the Amalgamated. Had the promoters of the merger gained possession of the Black Lake properties the disaster might have been avoided, but after all the genesis of the matter was the unreasonable overcapitalization which permitted the company barely three years of unhappy existence.

Neither of the companies could weather the storms of competition. The market was too limited and for several years prior to 1911 the annual output of asbestos had exceeded the sales. Price-cutting was resorted to and the Amalgamated Asbestos Corporation was reorganized as above; the Black Lake Company, defaulting its bond interest in February, 1912, was reorganized, first, under the name of The Black Lake Consolidated Asbestos Company, and then under The Black Lake Asbestos and Chrome Company, Limited.

The first statement of the Asbestos Company of Canada, covering the seven months between incorporation and December 31, 1912, showed a net profit over operating expenses and bond interest of $68,082.31. Three of the five plants were in operation, the condition of the market not warranting full production.

The annual statement issued on December 31, 1913, while not inspiring, showed a big increase in profits over the previous year. In 1911 the actual loss was $64,614, while the present

statement shows a profit from operation of $270,932, an amount sufficient to meet bond interest of $148,750, to allow $67,416 for renewals and betterments, and to leave $54,765 to be carried forward to surplus account.

The general manager, Mr. J. D. Sharpe, said the unfilled orders on hand amounted to $1,278,386, and contracts for delivery during 1914, were sufficient to keep the properties in full operation during the year, and that the physical condition of the properties was better at the present time than at any other period during the past three years.

Altogether the report was satisfactory; and it would appear that the future of the company will in time permit the payment of dividends on the preference stock, and remedy the faults of the position created when the original merger was formed in 1909.

Questions for Review.

1. What is meant by "insolvency"? What are the causes of "true" insolvency? of "legal" insolvency?

2. Analyze Bradstreet's table of insolvencies in Canada and show the percentage of failures from each cause.

3. What are the difficulties involved in making periodic evaluations of the assets of industrial concerns? of railroads?

4. What effect have ordinary trade conditions on the solvency of a business? What is the importance of periods of trade settlements in Canada's industrial life?

5. State the main provisions of the Dominion Winding-up Act.

6. When may a company be declared insolvent under that Act?

7. Do we need a general bankruptcy act in Canada? Under the B. N. A. Act where lies the authority over questions of bankruptcy and insolvency in Canada?

8. How can a corporation fail when its assets are greater than its liabilities?

9. What general committees are appointed when a company is reorganized? State the relative strength of the different classes of bondholders; of the stockholders.

10. Why must the stockholders and the junior bondholders provide the necessary cash to begin business? In what proportion should the cash be provided by each class?

11. What are the chief principles that should be followed in providing for a successful reorganization?

12. Why must fixed interest charges be reduced? To what extent should dividends replace interest charges?

13. How are the difficulties of exchanging securities for each type of security outstanding settled?

14. Give the history of any reorganization in Canada with which you are familiar.

Questions for Written Answer.

15. What kinds of companies can be liquidated or reorganized under the Dominion Winding-up Act? What proof will be accepted for legal insolvency?

16. State the principles according to which the different types of securities are exchanged for new securities.

17. To what extent should the stockholders be provided for in the reorganization of a company?

18. Bring up any difficulties.

LESSON XI.

Manipulation of Corporations by Officers, Directors and Stockholders.

The corporate organization of industry is undoubtedly the most economic and efficient method of conducting business that has ever been devised. Nevetheless, there are obvious drawbacks in the system, not the least of which is the comparative ease with which officers and directors may use the capital of others for their own advantage. Of course, we do not mean to say that dishonesty occupies any important place in the organization of business either in Canada or the United States; yet from time to time fraudulent and unfair, not to say unsound, methods do come to light which shake the confidence of the public in the integrity of those in control of large business interests. It may be worth while, therefore, to pass in review briefly some of the devices adopted by unscrupulous men to separate the investor from his money and property, so that the reader will be able to judge better what is unfair, unsound or fraudulent in conducting any particular business. In a word, it is essential that the banker should be able to discern at once the difference between legitimate and dishonest business methods, so that he may take action to protect himself and his clients' interests.

Mr. Seymour D. Thompson, in an address on "Abuse of Corporate Privileges," printed in the "American Law Review," says:—

"Our corporate life is honeycombed with corruption. A corporation is formed; its business is put into the hands of certain managers holding some of its stock and expert in the management of its business. Debts are created and the managers become the creditors. The result is that rings are organized within rings, wheels within wheels, combinations within combinations. The managers, in the character of creditors, seize upon and foreclose the property of the corporation, and by well-known processes squeeze the other stockholders out and become themselves the proprietors, with larger holdings than they had before. This sweating process, dignified by the name of foreclosing and reorganizing, has come to be a regular industry in our courts of justice. Courts of justice have neither the time nor the means to take upon themselves the management of all the corporations in the country; and therefore the outraged and complaining stockholders are told that they cannot come into court until they have exhausted all the remedies within the corporation."

It must not be supposed that these delinquencies are confined to men of great wealth, who are in control of huge corporations. Indeed, such men as a rule feel their responsibilities too keenly and have too high a sense of honor to practice the frauds mentioned. As a rule, it will be found that the officers and directors of the smaller and newly-organized corporations are the ones who abuse their positions and take advantage of the investing public. It may be said here, also, that those most competent to express an opinion on the subject are confident that the education of the public and the throwing of the light of publicity on corporation affairs are the best remedies for such abuses as have been mentioned.

Exorbitant salaries and stock commissions. One of the most common methods of appropriating the profits of a corporation is found in the paying of exorbitant salaries and the giving of commissions on the sale of stock by executive officials. A leading Canadian weekly made the following comment on such practices in the case of an insurance company that has been under fire for some time in this country:—

"It would seem that for some time past the shareholders have been suspicious that all was not right and have been carrying on a little private investigation on their own account. They have discovered, for instance, that the manager of the company has not only been getting the comfortable salary of $6,000 per year, but as a side issue he had a contract with the company whereby he received 10 per cent., or approximately $14 per share, on all new stock sold, and it further developed that new stock had been sold and issued at a cost to the company of from $2 to $7 per share, the balance accruing to the lucky manager.

"At the annual meeting of the Capital Company of Winnipeg, held last month, it developed that the company's affairs had been audited, but that, as the audit showed the company to be insolvent, the auditor was discharged and the report suppressed. In this connection the directors told the shareholders that the auditor's report was solely for their own information. Ordinary shareholders, of course, are not entitled to know as to the solvency of the concern into which they have put their money.

"In reply to the question as to the amount of insurance cancelled during the year, it was admitted to have been in the neighborhood of forty per cent., which, as the shareholders' report says, is an alarming state of affairs, and adds only another reason for a searching investigation into the company's affairs. It was also admitted by the management at the meeting that they were unable to write new insurance in the Province of Manitoba, owing to the company's inability to

make the necessary deposit with the Inspector of Insurance, and that, while a Dominion charter had been secured, it was inoperative owing to the company being unable to comply with the terms necessary, which are that the company should satisfy the Federal Insurance Department that they had a clear $100,000 over all liabilities.

"The Board of Directors, according to the report of the committee of shareholders, used every possible means to stifle a full and complete investigation of the company's affairs, and it was only after the utmost persistence that the directors finally complied, the annual meeting being adjourned to a later date to allow of some investigating being done.

"There is one thing certain, if the Capital Life of Winnipeg is not insolvent, it deserves to be with the management that it has had, and the sooner the shareholders get to the bottom of its affairs the better they will be off. In the interval, we would warn one and all that the company is not safe to insure th, and at the moment it cannot do business in any Province where there is an insurance department that knows its business."

It is very difficult in such cases to prove fraud, especially if the officers and their friends control a majority of the stock. Nevertheless, the practices mentioned in connection with the management of the company cannot be justified, and certainly injure the position of the minority stockholders.

Fraudulent contracts and new companies. A practice all too common is the creation of an understanding between the purchasing officials of a corporation and the firms from which supplies are bought, whereby the former secure a rake-off on all contracts entered into. As a rule, however, the subordinate official is not the real culprit, the true offenders being officers higher up in the concern. A small group of officers or directors may gain control of the stock of a company and then proceed to enter into contracts that absorb all the profits of the corporation, leaving absolutely nothing for the minority stockholders in the shape of dividends. Here, again, it is difficult to secure a remedy and prove fraud.

Again, officers of a corporation are in a position to discover what part of the business yields the best returns. In some instances they take advantage of that knowledge to promote independent enterprises in the best territories, and to practically hand over the business in these localities to the new concerns. Or, again, after having secured capital from investors to promote and develop a particular invention or commodity, subsidiary companies have been formed and given special contracts, whereby they have absorbed all the profits. This is done, of course, without the knowledge or consent of

the stockholders who do not form part of the inner "ring." In these ways the returns to the parent company are reduced; while the subsidiary companies that are controlled by the interested officials of the parent concern receive practically all the profits. It goes without saying that the ethics of such a procedure cannot be justified, however hard it may be to prove fraud in a court of law.

Unfair use of inside information. A corporation official is justified, on the whole, in dealing in the securities of his own company provided he does not injure the business in any way in the hope of gaining by "short" sales. Officers and directors, from the ethical as well as the legal point of view, have a perfect right to sell stock or to buy it according to their judgment of prevailing or future market values. This, however, is quite a different matter from their attempting to enrich themselves at the expense of the concern.

For example, it is entirely wrong for an official to sell the stock of his corporation unless he has received explicit authority so to do. Officials have been known to sell stock to buyers at the prevailing market price, and then to issue to themselves treasury stock at a lower price. This is a fraudulent transaction, and the courts have ordered the difference in price to be made good to the corporation at the request of shareholders of the company.

Another example of the misuse of inside information is found in the manipulation of a corporation's property when it is known that it must soon go into the hands of the liquidator. There are cases on record which show that officers have exchanged their stock for the interest-bearing obligations of the concern, and have even placed these securities in the hands of a third party, so that the claim could be enforced. Such transactions, however they may appear in the eyes of the law, are dishonest, and injure other stockholders.

An official, especially if he is treasurer of his company, may take advantage of his position to buy up the notes or other obligations of the concern at a discount and redeem them at their full face value. Of course, such a transaction will take place only if the company is in difficulties, for otherwise the notes would not have gone to a discount. The courts have held that such a practice is legal, as the funds of the corporation are supposed to meet obligations as they occur, and are not set aside to discharge any particular debt. But once more it should be observed that the whole transaction is essentially dishonest, as the officer has made use of his position to secure a private profit. In this as in the other cases cited there has been an abuse of a position of trust, and the officials have been unfaithful to the company which has employed them.

It would be unfair to say that the taking of exorbitant salaries, or collusion in making contracts, or the formation of new companies for especially profitable business, or misuse of confidential information characterizes corporate activity to any great degree either in Canada or the United States. Yet these devices are adopted at times by unscrupulous officers to enrich themselves at the expense of other stockholders. The chief, if not the only, remedy for these abuses is to turn on the light, and to educate investors so that they will know how to protect themselves against dishonesty and fraud.

Manipulation by directors. It is difficult to draw the line between manipulation by officers and manipulation by directors, because in some cases collusion between the two is essential for carrying out any unfair or dishonest scheme. There are certain methods that are followed, however, that are intended primarily to benefit the directors, and with these we may now deal.

There are, in general, four methods of transferring the assets of a corporation or an undue share of its profits to the directors. These are:—

(a) Fraudulent purchases and contracts.

(b) Formation of new companies, especially for profitable business.

(c) Deceiving the general body of stockholders by juggled accounts.

(d) Forcing the company unnecessarily into the hands of the liquidator.

The first two methods of "milking" a corporation's profits have already been discussed, and directors who are engaged in dishonest practices merely vary such methods. For example, the directors of a corporation are usually very closely associated with its promoters, and in the majority of instances share in the profits of promoting the enterprise. There are cases on record where the directors have permitted the promoters to get exceptionaly large returns, more than they were reasonably entitled to receive, the object being to share the spoil between those interested. Plainly an injustice is done here to the great body of shareholders who have put their money in the business.

Many examples might be given of deals between the directors of a corporation on the one hand and themselves as individuals on the other. In one instance the directors of a company after having bought a large block of land caused the company to develop part of the property by erecting handsome

and extensive buildings thereon. They not only m large profits on the land sold to the corporation, but also on the land in the immediate vicinity which they had bought on speculation. Readers will recall many such cases concerning which they are personally cognizant. It is said, and apparently with good reason, that certain men prominent in Canadian public life have become wealthy through securing inside information as to the location of new railway lines in the West. Directors who buy land on speculation ond then sell it to their own company at fancy prices are certainly taking advantage of the stockholders as a class.

Selling bonds to stockholders. In some cases the directors, in order to protect themselves or a subsidiary company in which they are interested, have practically forced stockholders to buy bonds to provide capital for a losing venture, threatening the stockholders with the total loss of their property unless they do so. Here the directors and their friends are the chief, if not the only, gainers from the transaction, the stockholders throwing good money after bad.

A prominent Canadian financial journal recently commented on a proposed sale of bonds to stockholders, where it was maintained that absolutely no security was offered to protect the bonds. The article, together with the reply of the solicitors of the corporation, follows, the names of the companies concerned being changed:—

"Some very remarkable 'bonds' have been offered to the Canadian public during the last three years or thereabouts, but none of them, we believe, has been more remarkable than the $25,000 issue of 6 per cent. bonds which it is proposed to create by By-law "A" of the Bugle Realty Company, Limited, which will be voted upon at a special general meeting of shareholders at the office of the company in the Annex Building, Montreal, on Monday next.

"A company called Jones-Brown Limited, of Toronto, owes the Bugle Realty Company $46,000, of which $6,000 is accrued interest to date and the balance is instalment payments, the whole in connection with the purchase from Bugle of a certain real estate property for the sum of $100,000. Of this price $40,000 represents the assumption by Jones-Brown of first and second mortgages to that amount; the balance was to be paid to the Bugle in cash instalments, and $20,000 has been so paid.

"In order to hold the property and remain solvent, the Jones-Brown concern is of course obliged to pay the interest on the first and second mortgages. But the Jones-Brown concern is 'unable to meet the February interest on the first mortgage' to Bugle stockholders, not to mention of course, the $6,000 accrued interest on the purchase money, now due to Bugle.

The Bugle Company, therefore, in a disposition of generosity which unfortunately is all too rare in this cruel world, proposes not merely to let the Jones-Brown concern go on owing the instalments and interest on the purchase money, but also to lend the Jones-Brown concern some $110,000 with which to keep the first and second mortgage-holders in a state of quietude. It is true that the Jones-Brown concern is required to pay a premium and interest on this loan which together will amount to 13 per cent. per annum for five years, but the Bugle Company gets no further security for this sum than it already had for the payment of the balance due on the purchase money, namely, a charge against the property transferred.

"In order to obtain the money to advance to Jones-Brown, the Bugle directors are calling upon their shareholders to take up 'bonds' to the extent of 40 per cent. of their stock holdings. 'These bonds,' observes the president in the letter already quoted, 'would have as security the mortgage of $46,000 due by Jones-Brown Limited.' This is an entirely novel doctrine of bond security. The 'mortgage' presumably is already the property of the Bugle Company. The shareholders of the Bugle Company are being asked to buy bonds based on a security which already belongs to themselves. It is perfectly simple, only very new. Smith owes Jones a hundred dollars—which he cannot pay, nor can he pay the interest, and he needs more money anyhow; so he comes to Jones and says: 'Jones, lend me another hundred dollars on the security of that claim that you have against me for the first hundred.' And Jones falls for it! Perhaps.

"The Bugle president speaks of 'the mortgage of $46,00 due by Jones-Brown.' In the by-law, which is more likely to be legally correct, this 'mortgage' is spoken of as 'the hypothec existing in the company's favor over the property sold to Jones-Brown, Limited.' But whether it is a mortgage or a hypothec does not greatly matter. If it is a mortgage, it is a third mortgage, preceded by first and second mortgages covering 40 per cent. of the value of the property as fixed in open sale before the war; it covers the value of the property after the first 40 per cent. and up to 80 per cent. of this before-the-war valuation. As a mortgage, it is a joke.

"It may be very necessary for the shareholders of Bugle to do something to protect their equity in the property, which they have plainly allowed to pass into hands incapable of protecting it. But they should understand quite plainly that insteady of making a 13 per cent. investment they are financing a forlorn hope for keeping a real estate speculation out of the hands of its creditors. And they should see to it very carefully that any funds which they are now compelled to put up shall be used for the protection of the property from its mort-

gage creditors and for no other purpose. The proposed by-law does not even state for what purpose the proceeds of the issue are to be employed."

The reply of the solicitors of the Bugle Realty Company follows:—

"We are the solicitors for that company, and under the instructions of the board of directors we prepared the draft of the by-law which it was proposed to submit to a special general meeting of the shareholders of the company for their consideration.

"We have read and carefully considered your article, and we beg to say on behalf of the officers and directors of the Bugle Realty Company that your article is inaccurate and misleading.

"It is true, as you point out, that Jones-Brown, Limited, of Toronto, owes the Bugle Realty Company some $40,000 and accrued interest, representing the balance of price of sale to that company.

"When the Bugle Realty Company sold to Jones-Brown, Limited, the property in question there were first and second hypothecs, to which you refer, covering the property for which the Bugle Realty Company was liable as part of its perchase price, and which Jones-Brown, Limited, in turn assumed as part of its purchase price. Jones-Brown, Limited, having failed to pay not only the interest due to the Bugle Realty Company but also the interest due on the underlying hypothecs it was essential, in order that the shareholders of the Bugle Realty Company could protect their equity in the property, that they pay the interest on these under-lying hypothecs for which, of course, the Bugle Realty Company was always liable.

"In order to provide the funds necessary to meet these and other obligations, and protect the property, the directors of the Bugle Realty Company submitted to the shareholders of that company a proposal that they should create an issue of bonds or debentures, and should secure that issue by assigning to a trustee for the holders of the proposed bonds the equity of the Bugle Realty Company in the property now held by Jones-Brown, Limited, and the obligations of Jones-Brown, Limited. The bond issue would be a bond issue subject to underlying hypothecs it is true, but in that regard would not be by any means 'unique' as your article states.

"The proposed bond issue is, in our opinion, a perfectly legal transaction from every point of view, and we have so advised the directors. It enables the Bugle Realty Company to give a proper preference to those of its shareholders who come forward in this emergency and provide the company with the funds necessary to protect its property over those other shareholders who cannot or will not do so.

"Your Smith-and-Jones anecdote is amusing but utterly inapplicable. The Bugle Realty Company will itself owe to those who take up the proposed bonds any amount subscribed on the bonds; and, in addition to this company's obligation, the subscribers will have a transfer of the company's 'equity' in the property sold to Jones-Brown, Limited.

"The directors of the Bugle Realty Company, after due consideration, decided unanimously that it was inadvisable from the point of view of the Bugle Realty Company to take steps to cancel the sale to Jones-Brown, Limited, and to have the property sold by the sheriff. They considered it preferable, under prevailing conditions, that all the proposed financing as to discounting bonds, interest, taxes, etc., be done for the account of Jones-Brown, Limited, and with ultimate recourse against that company.

"We may add that at a special meeting of the shareholders of the Bugle Realty Company, at which the matter was fully discussed, there was no objection taken by any shareholder to the proposed plan.

"In regard to the last paragraph of your article, we trust that you do not mean to suggest that the amount of money proposed to be raised by the company will be applied to anything but proper purposes. Such an inference would be altogether unfair and unfounded. The proceeds of any sale of these bonds will be devoted to paying off hypothecary obligations of the company having precedence of the hypothec securing the proposed bond issue, and for taxes, or otherwise for the protection of the interests of the bondholders and of the company itself.

"We trust that you will take steps to remedy the erroneous impression created by your previous article."

The reader will observe that no judgment has been passed on the legitimacy of this proposed bond issue. The facts are presented merely to show how bonds are issued that may be practically worthless, in which the stockholder puts his money to protect men who may be acting in collusion with the directors of another concern. In all such transactions the courts will assume that a corporation is honestly managed in accordance with the wishes of the stockholders unless the contrary is absolutely proved.

The formation of new companies; juggling accounts. The looting of a corporation's treasury by the formation of new companies by its directors is similar to the practice followed by officials. The directors in this case organize subsidiary companies, of which they are the chief stockholders, and then arrange for favorable contracts between the parent company and its subsidiaries, whereby the chief profits go to the latter concerns. In other cases where the same men act as directors

on the boards of two or more corporations they may put agreements through which yield profits to themselves personally, and not to the corporation whose business interests they are expected to protect.

There have been some cases recently before the Canadian public that illustrate the other method—the juggling of accounts—by which the stockholders of a company may be injured by unscrupulous directors. In these cases the annual balance sheet and the statement of profit and loss showed that the corporations were in a flourishing condition, whereas assets had diminished in value and dividends were paid out of capital account. In these instances the directors hope to preserve the credit of the concern until they can dispose of their holdings; then the report of a capable and properly qualified auditor is seccred by stockholders whose suspicions have been aroused, and the corporation goes into bankruptcy. In such cases the concealing of the true condition of the company permits directors to dispose of their holdings or take profits that have not been earned. It is the stockholders that remain with the concern that finally lose their money. The remedy for this state of affairs is the insistence by the stockholders of frequent reports on the standing of the company by properly qualified accountants.

Damaging a corporation's securities and property. Directors have sometimes used all earnings to improve the value of a corporation's property, leaving nothing for interest or dividends. When the concern has been forced into liquidation they have bought up the mortgages and bonds at a heavy discount, and through their control of stock, and mortgages, got possession of a really valuable property. In some cases the stockholders of the old corporation have forced the directors to yield possession of the property, the latter retaining only the equity that they had in it through their investments.

In other instances the directors have sold some property of the corporation to another corporation, in which they were interested, taking in payment securities of no value. The second company has then realized upon the property that was sold to it, in the proceeds of which sale the directors have shared. The corporation that holds the securities in this case suffers a direct loss of assets, as nothing can be realized on the securities held. Many other illustrations might be given where dishonest directors enrich themselves at the expense of the corporation whose business is entrusted to their management.

Under the various Companies Acts in Canada it is provided that no mortgage shall be placed on the permanent assets of a corporation without the con-

sent of a majority of the value of the stock outstanding. One of the chief lessons to be learned from the fraudulent manipulation of the assets of a corporation by the directors is the absolute necessity of control of the property being kept by the general body of stockholders. While this in itself will not prevent many of the practices mentioned, it will prove a strong bulwark of defence against the loss of permanent assets by the manipulation of the property by dishonest directors.

Manipulation by stockholders. It must not be supposed, however, that the officers and directors are the only dishonest men who take advantage of the corporate organization of business to enrich themselves at the expense of others. The stockholders at times attempt to defraud their creditors; and in other instances the majority interest in a corporation takes advantage of the minority shareholders. We shall give a number of examples to illustrate these practices.

Wholesalers and manufacturers in Canada are all too familiar with the trick of individuals and partnerships buying stocks of goods on credit, disposing of them quickly, and concealing the profits, while they shortly after go into liquidation. Small, close corporations have also proved themselves adept at this game. The scheme is a plain case of fraud, and is thoroughly understood by all credit-men.

A different method, but one producing the same results, is found when the stockholders pile up large debts, allow the property to depreciate, and in the meantime pay themselves heavy dividends out of earnings—earnings that should have gone into the property to maintain its value. When the property is turned over to its creditors there is little or nothing left for them. Of course, when a bond issue is put out, one of the stipulations in the mortgage, if properly drawn, is that the property will be kept in a proper state of repair and not be permitted to depreciate in value. If the trustee, however, neglects to enforce the conditions of the mortgage the stockholders may, by the process mentioned, appropriate all its value for themselves. Many instances might be quoted showing how this has been done, especially the management of railroad property in the United States.

Again, stockholders may form subsidiary concerns which will yield large profits and carry on these enterprises largely on the credit of the parent organization which is all the time losing money. An example of this is found in the case of a company that owned an amusement park in a large city in the United States. The company controlling the park made no profits, although the amusement enterprises run in con-

nection earned large returns. The stockholders of the parent organization controlled the other enterprises, where the real profits were made. At the same time, because of the apparent prosperity of the main business, large sums of money were secured on the sale of bonds, on which no return could be made. The difficulty was settled out of court by the stockholders of the subsidiary enterprises settling the claims of the bondholders. It is doubtful, however, whether they could have been compelled legally to settle the just claims of their creditors.

Squeezing the minority interest. In many instances the majority interests have enriched themselves at the expense of the minority stockholders. Illustrastrations of such practices will occur to every reader.

An example of the methods followed here is found in the leasing of the corporation's property to a subsidiary concern controlled by the majority interests. The lease may yield only a small rental, while the profits of the business go to the majority stockholders interested in the subsidiary concern.

Many instances are on record where the majority stockholder has dominated the board of directors and has induced them to buy worthless property in which he was interested, or worthless bonds in another corporation controlled by him. In these cases the majority stockholder diverts property to himself for his own direct, personal gain; and yet it is exceedingly difficult to prove fraud.

A quite common practice is to form various subsidiary organizations controlled by the majority stockholders in the parent concern. One of these subsidiaries is given an air of prosperity by the heavy sales it makes to the other companies. The majority interests in the parent company are able to sell the stock of this apparently prosperous subsidiary concern, because of the excellent profits disclosed by its books. After all the stock has been sold by the manipulators, except a controlling interest, the various subsidiary concerns close their doors. The stockholders of the company that has sold them heavy orders of goods, or real estate, have nothing to show for their money except the paper certificates they hold. The company advertised and kept before the public, in such cases, is never associated with the parent organization. The majority of its shares are kept in the hands of the manipulators to prevent investigation and litigation. Many such cases of "high finance" have been brought to light in the United States, especially in connection with real estate transactions, in which the buyers of stock in apparently prosperous companies have been practically robbed.

What are the remedies for this, and the other instances of unscrupulous manipulations that have been mentioned? Mr. Lough (Corporation Finance, p. 448) suggests the following:

1. Security-holders should insist on complete and absolute publicity of the affairs of their company.

2. Stockholders should attend meetings and take an active interest in all that goes on in the corporation.

3. The cumulative system of voting should be introduced, whereby each stockholder has a chance to be represented.

4. Explicit provisions should be inserted in the corporate by-laws as to salaries of officers, amount of indebtedness to be incurred, amount of surplus to be set aside each year, and so on.

It should be observed, in concluding this Lesson, that the instances of fraud or dishonesty that occur among corporations, are almost insignificant in comparison with the bulk of the business done. Nevertheless, it is well to understand the methods of clever and unscrupulous manipulators, in order that the investor, and those whose business obliges them to deal with corporations, may know when to be on their guard against dishonest and illegal practices.

Questions for Review.

1. Why does the corporate organization of business offer special opportunities to the manipulator? Why is it easier to carry on manipulation in a close, than in an open, corporation?

2. What are the particular corporation abuses that are enumerated by Mr. Seymour Thompson? Are such abuses as prevalent in Canada as in the United States? Why, or why not?

3. Are rich men, who control capital investments, any more likely to fradulently or dishonestly take advantage of their position than men of less wealth? Why, or why not?

4. How may officers manipulate property to their own advantage by taking excessive salaries? Give examples that have come under your own observation.

5. How may officers manipulate corporations (a) by forming subsidiary companies; (b) by entering into dishonet contracts; (c) by taking stock commissions?

6. Show how an unfair or dishonest use of inside information may enrich the officers of a corporation.

7. What are the particular methods followed by directors in manipulating their companies for their own profit?

8. How may directors profit by forcing their own corporation into bankruptcy?

9. How may directors make dishonest gains by juggling the accounts of their company? Give examples that have come under your own observation.

10. How may directors make nnfair profits by forming subsidiary companies?

11. How do majority interests defraud minority stockholders of their profits or property?

12. How may the stockholders defraud their creditors? Is it as easy to do so as in the case of the individual business or the partnership?

13. How may stockholders defraud bondholders by forming subsidiary concerns?

Questions for Written Answer.

14. What methods should be adopted by stockholders to prevent manipulation by officers and directors?

15. How can the bondholders protect themselves against the unfair practices of stockholders?

16. In what way can the minority interest protect itself against manipulation by the majority interest?

17. Bring up any difficulties.